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AZ CORP COMMISSION
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IN THE MATTER OF THE APPLICATION OF
PIMA UTILITY COMPANY, AN ARIZONA
CORPORATION, FOR A DETERMINATION OF
THE FAIR VALUE OF ITS UTILITY PLANT AND
PROPERTY AND FOR INCREASES IN ITS
WATER RATES AND CHARGES FOR UTILITY
SERVICE BASED THEREON.

Docket No. W-02199A-11-0329

IN THE MATTER OF THE APPLICATION OF
PIMA UTILITY COMPANY, AN ARIZONA
CORPORATION, FOR A DETERMINATION OF
THE FAIR VALUE OF ITS UTILITY PLANT AND
PROPERTY AND FOR INCREASES IN ITS
WASTEWATER RATES AND CHARGES FOR
UTILITY SERVICE BASED THEREON.

Docket No. SW-02199A-11-0330

RUCO'S OPENING BRIEF

Arizona Corporation Commission

DOCKETED

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DOCKETED BY	<i>JS</i>
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1 **INTRODUCTION**

2 The Residential Utility Consumer Office ("RUCO") submits this Brief in response to
3 Pima Utility Company's ("Pima" or "PWC" or the Company") request that the Arizona
4 Corporation Commission ("Commission") authorize a rate increase of \$739,556 for its Water
5 Division and \$425,259 for its Wastewater Division.¹ While the Company and RUCO are in
6 agreement on the majority of the issues there still remains in dispute a major issue which
7 was much of the focus of the underlying hearing - the treatment of income tax expense for
8 Pima, an S corporation, for income tax purposes.

9 Simply stated, the Company is asking Pima's ratepayers to pay Pima's shareholders'
10 personal income taxes related to Pima's income.² The truth be told, it is difficult to image
11 why the Commission would or should entertain such a request. By choosing to organize as
12 an S corporation, Pima has voluntarily elected not to pay federal or state income tax to avoid
13 double taxation. Pima can change its organizational status at any time if it feels
14 disadvantaged in any way³.

15 As explained more fully in the Brief, the Commission should reject Pima's request for
16 three reasons. First, having captive ratepayers pay the personal taxes of Pima's
17 shareholders is bad public policy. Second, the reasons provided by Pima to justify
18 increasing rates to cover shareholders' taxes are unpersuasive. Third, Pima's proposal
19 _____

20 ¹For ease of reference, trial exhibits will be identified similar to their identification in the Transcript of
21 Proceedings. The transcript volume number will identify references to the transcript.

22 ² RUCO points out that more than half of Pima's requested rate increase for wastewater and about a third of
23 the requested rate increase for water is to cover shareholder personal income taxes.

24 ³ Pima is a Class B Arizona public service corporation currently organized as an S corporation under Subtitle
A, Chapter 1, Subchapter S of the Internal Revenue Code. R-9 at 2. S corporations elect to pass corporate
income, losses, deductions and credits through to their shareholders for federal tax purposes. Id. at 3.
Shareholders of S corporations report the flow-through of income and losses on their personal tax returns and
are assessed tax at their individual income tax rates. This allows S corporations to avoid double taxation on
the corporate income. Id.

1 violates the constitutional requirement that the Commission set rates that are just and
2 reasonable. (AZ Const. Art. XV, Sec. 3) It is neither just nor reasonable for ratepayers to
3 pay an expense of the utility that does not exist. Whether for policy or legal reasons, the
4 Commission should reject Pima's request to increase rates to cover the tax liability of the
5 earnings for Pima's investors.

6
7 **I. THE RECOVERY OF INCOME TAX EXPENSE**

8
9 **A. AS A MATTER OF PUBLIC POLICY, ALLOWING A SUBCHAPTER S CORPORATION TO RECOVER INCOME TAX FROM RATEPAYERS IS POOR PUBLIC POLICY.**

10
11 **1. Recovery of personal income taxes is a substantial portion of the requested rate increase.**

12
13 RUCO questions how the utility can explain to its customers why over 50% of its
14 requested wastewater and 30% of its requested water increase is to pay for taxes – an
15 expense the utility does not pay. It is blatantly unfair to require Pima's customers, most of
16 whom are retirees, to pay the personal income taxes of Pima's shareholders, most of whom
17 are family trusts.

18 The Company argues that the Commission should adopt a policy of imputing income
19 taxes because FERC has adopted this policy. A-12 at 16-18. However, FERC policy is not
20 controlling precedent in Arizona.

1 FERC's new policy, not surprisingly, has met some due criticism. David Cay
2 Johnston, a *Tax Analysts'* columnist, said the following about FERC's policy in his column
3 entitled, "Master Limited Partnerships; Paying Other Peoples Taxes⁴."

4 Wouldn't it be fantastic if someone else paid your income taxes for
5 you? Imagine all that extra money in your bank account. You could
6 pay off your debts, save, and even splurge.

7 Of course, for the person who paid your income taxes it would be
8 awful. They would have to pay their own income taxes and then,
9 out of what was left, pay yours.

10 Congress would never enact such a law, right?

11 The good news is that Congress has not enacted such a law. The
12 bad news is that buried deep in the fine print of the *Federal*
13 *Register* is a regulatory rule that has the same effect.

14 The requirement that forces you to pay the personal income taxes
15 of others applies -- for now -- only to owners of rate-regulated
16 pipelines organized as master limited partnerships, or MLPs.

17 It is not surprising if you have never heard about this tax-shifting
18 rule. Unless you dig into the inordinately arcane proceedings of the
19 Federal Energy Regulatory Commission (FERC), a small
20 government agency that wields enormous economic power, you
21 would be in the dark. The commission gets almost no news
22 coverage. The very few, and brief, news reports on the cases
23 related to the MLP charge missed the tax issue.⁵

24 With regard to FERC's new policy and its cost to ratepayers, Mr. Johnston reported
the following:

The math here is stunning. When rates include a tax that does not
exist, the investors make out like, well, bandits. Investors in an

⁴ The FERC policy and the Circuit Court cases mentioned above which address the policy dealt with Master Limited Partnerships, which like S corporations and LLC's are pass-through entities for tax purposes. The resulting FERC policy, however, addresses pass-through entities including LLCs.

⁵ RUCO-9, Exhibit 1.

1 MLP pocket 75 percent more in after-tax profits than they would if
2 they invested in a traditional corporation owning a pipeline.

3 You will not find this math in Judge Sentelle's 2007 decision. Had
4 he done the math, would the outcome have been different?

5
6 The tax shifted to consumers looks to be as much as \$1.6 billion a
7 year for gas pipelines and \$1.3 billion more for petroleum pipelines.
8 Industry data show oil pipeline profits are an eye-popping 42
9 percent of revenues, more than four times the margin for the
10 12,000 largest corporations.

11 This estimate has to be heavily hedged because, amazingly, FERC
12 does not issue any statistical reports on either the cost of this tax
13 transfer or of the underlying data from which a solid estimate could
14 easily be calculated. A new law requiring either truth, or at least
15 transparency, in regulations that shift tax burdens would help here,
16 but the Wall Street-friendly Obama administration seems unlikely
17 to take up such a cause. (RUCO-9, Exhibit 1)

18 **a. Arizona is not bound to follow FERC**

19 Arizona has always been proud of its independence. Arizona also has different policy
20 and legal considerations than does the federal government, or Texas, or other states that
21 have adopted some variation of the FERC policy. Arizona's Constitution, for example, is
22 different than the federal model in many ways⁶. It is no surprise that many of Arizona's
23 Founding Fathers were "very much opposed to putting in the constitution of Arizona things
24 that we have simply gathered from other constitutions." John D. Leshy, "The Making of
Arizona Constitution", (20 Ariz. St. L.J., 1, 99 (1988)). Arizona should not adopt a policy just
because the federal government has chosen to do so. The policy must make sense for
Arizona.

1 **b. Other states reject FERC policy**

2 Perhaps these same flaws explain why there is no support for the policy among the
3 eastern commissions.⁷ In fact, it appears that few states have adopted this policy.⁸ Closer
4 to home, the California Public Utilities Commission, on June 1, 2011, denied Santa Fe Pacific
5 Pipeline, L.P. ("SFPP") recovery of imputed tax. The California PUC noted that it only
6 provides an allowance where the utility expects to incur an expense:

7 " If for example, SFPP were suddenly able to conduct business
8 entirely without paper, solely using electronic communications,
9 there would no longer be a need to purchase paper, ink, pens,
10 postage, storage boxes, file cabinets, etc. No one would
11 reasonably argue that SFPP should still have a theoretical
allowance for paper and pens, and related items included in its
expense forecast. If there is no likely expense, there should be no
expense forecast in rates.

12 ...if there is no taxation on earnings while the earnings are still
13 within the operating control of SFPP, there is no income tax
14 obligation to recognize as a utility operating expense in rates."⁹

15 ⁶ For example, special controls on the legislative process, Ariz. Const., Art. IV, part 2, §§13,14,20, and line-item
16 executive veto, Id. Art. V, §7

17 ⁷ Florida: *Re Farmon Water Resources LLC*, 2004 WL 2359423 (Fla. P.S.C.), Indiana: *South Haven*
Waterworks v. Office of Utility Consumer Counselor, 621 N.E.2d 653 (Ind.App. 1993), Illinois: *Monarch Gas Co.*
v. Illinois Commerce Comm'n, 366 N.E.2d 945, 51 Ill.App.3d 892, (1977), Kentucky: *Application of Ridgelea*
Investments, Inc. 2008 WL 4696006 (Ky. P.S.C.), New Hampshire: *Re Concord Steam Corp.*, 71 N.H. P.U.C.
18 667 (1986), Vermont: *Re: Existing Rates of Shoreham Telephone Company, Inc.*, 181 Vt. 57, 915 A.2d 197
(2006).

19 ⁸ Some states have adopted variations of the FERC policy – see for example Kansas: Must present
"substantial competent evidence of ... the shareholders' actual income tax liability" – no hypothetical tax
recovery.

20 *Greeley Gas Co. v. State Corp. Com'n of State of Kan.*, 15 Kan.App.2d 285, 807 P.2d 167, (Kan.App. 1991);
Home Telephone Co., Inc. v. State Corp. Com'n of State of Kansas, 31 Kan.App.2d 1002, 76 P.3d 1071
21 (Kan.App. 2003). New Mexico – the "New Mexico Rule" – "[A]n amount equal to the tax the Company would
pay, if incorporated, is a reasonable and realistic amount to be deducted from the Company's taxable income
22 for rate making purposes." *Moyston v. New Mexico Public Service Commission*, 63 P.U.R.3d 522, 76 N.M.
146, 412 P.2d 840 (1966). Texas – followed the New Mexico rule - *Suburban Utility Corp. v. Public Utility*
Com'n of Texas 652 S.W.2d 358 (Tex. 1983). The Texas Court held that Suburban was entitled to recover
23 income tax expenses equal to the lesser of the income taxes actually paid by its shareholders or the tax it
would pay if it were a C-Corp.

24 ⁹ *ARCO Products, Mobil Oil and Texaco vs. Santa Fe Pacific Pipeline*, Dec. No. 11-05-045 (Case 97-04-
025 at p. 21)

1 ***c. FERC Policy was reluctantly upheld by the federal court***

2 It is true that from what can only be described as a long and tortured history, FERC's
3 current policy is to impute income tax to pass-through entities at the top marginal tax rate. It
4 is also true, as the Company points out, that the District of Columbia Court of Appeals has
5 upheld FERC's policy. A-12 at 16-20. However, it is the same court that, in 2004, struck
6 down FERC's attempt to "...create a phantom tax in order to create an allowance to pass-
7 through to the ratepayer."¹⁰ While the court later upheld FERC's new policy based on the
8 ground that FERC had "justified its new policy with reasoning sufficient to survive our review,"
9 it is hardly a glowing endorsement or even support for FERC's new policy of imputing income
10 taxes at the maximum marginal tax rate¹¹. The Court deferred on the wisdom of the policy
11 itself. "We need not decide whether the Commission has adopted the best possible policy as
12 long as the agency has acted within the scope of its discretion and reasonably explained its
13 actions."¹²

14 The Court recognized that the question was clearly a policy choice which is
15 FERC's responsibility and not the Court's, and the Court is limited to ensuring that
16 FERC's decision making is "...reasoned, principled and based upon the record."¹³

17 Neither the Company nor the industry has shown why it makes sense for ratepayers to
18 pay Pima shareholders' personal income tax when the utility itself has chosen not to pay
19 income taxes. The Commission should reject the Company's recommendation.

20
21
22 ¹⁰ *BP West Coast Products v. FERC*, 374 F.3d 1263, 1291, 362 U.S. App. D.C. 438, 466, 160 Oil & Gas
Rep. 703 (2004).

23 ¹¹ See *Exxon Mobil Oil Corp. v. F.E.R.C.*, 487 F.3d 945, 948, 376 U.S. App. D.C. 259, 262, 166 Oil & Gas Rep.
230, 233. (2007)

24 ¹² *Id.* at 955.

¹³ *Id.* at 953.

1 **2. Ratepayers should only pay expenses incurred by the utility.**

2 It cannot be stressed enough – **the S corporation does not pay income tax.**

3 Ratepayers should only pay for expenses incurred by the utility. Nonetheless, the Company
4 argues that there is no such thing as a phantom income tax. A-12 at 8. The Company
5 claims that income determines tax liability and Pima generates taxable income, and
6 therefore, income tax liability. Id. The fact that an S corporation does not pay income tax,
7 according to the Company is a mere “technical distinction.” Id. at 7. However, it is more than
8 a technical distinction. Pima shareholders pay personal income taxes, not corporate taxes.
9 The shareholder’s income tax filings are not subject to the federal or state codes pertaining
10 to corporate income tax. R-10 at 5. The Company’s shareholders receive their pro-rata
11 share of earnings, losses, and credits which are treated as personal income for income tax
12 purposes. Id. at 5-6. These earnings or losses are subject to the shareholder’s individual
13 tax rates. Id. The difference between individual and corporate income taxes is great – there
14 is far more than a mere technical distinction involved here.

15 By choosing to distribute utility revenues and realize the income earned, the
16 shareholders took advantage of the tax benefits realized by the federal Tax Reform Act of
17 1986 (“TRA 86”). TRA 86 had a large effect on those corporations eligible to elect
18 Subchapter S status. Shareholders of C corporations could now switch to Subchapter S
19 status to take advantage of the lower individual income rates and subsequent reduced tax
20 liability.

21 Pima converted to Subchapter S status in 1986. Transcript at 389. Now, despite the
22 preferential tax treatment Pima receives pursuant to the reforms of TRA 86, it wishes its
23
24

1 shareholders to be relieved of all tax liability since their tax liability would be covered by
2 ratepayers. Simply put, this is a money grab that should be denied.

3
4 **B. PIMA'S ARGUMENTS IN SUPPORT OF A HYPOTHETICAL TAX ARE UNPERSUASIVE.**

5
6 **1. The failure to include phantom income tax expense does not create**
7 **an artificial impediment to invest in utility infrastructure in Arizona.**

8 This argument lacks merit. Its premise has no support because Arizona utilities have
9 not migrated to C corporation status in order to eliminate any alleged "impediments" to
10 infrastructure investment. To the contrary, since the 1980s when the Commission
11 established its policy to deny recovery of personal income taxes of shareholders of S
12 corporations, there has been an increase in the number of utilities switching to or organizing
13 as S corporations or LLCs. Particularly after the passage of TRA 86, utilities have chosen
14 to take advantage of the tax benefits afforded by S corporations and LLCs.

15 Arizona water/wastewater utilities have experienced phenomenal customer growth in
16 the last few decades. The need for additional infrastructure has been a challenge.
17 Additionally, water utilities have had to comply with the federal Safe Drinking Water Act, the
18 Arizona Groundwater Code, and tougher EPA arsenic standards. Utilities, like Pima, have
19 risen to the challenge and have done so without changing their corporate status. Now that
20 Pima is built out, it is difficult for RUCO to appreciate the argument that allowance of
21 recovery of personal income taxes will incent needed infrastructure when Pima was able to
22 meet the infrastructure demands when the challenge was the greatest without choosing to
23 change its corporate status.

1 The Commission's policy will not spur investment in Arizona. The S corporation
2 status allows utilities to avoid double taxation – paying corporate income taxes on revenues
3 and also personal income taxes on the after-tax dividends. It allows start ups, as the
4 Company even admits, to raise capital and lower its capital needs. R-9 at 5. These benefits
5 are the attraction of organizing as an S corporation.

6 **a. Pima chose S corporation status in 1986**

7 Ironically, the Company is perhaps the best example of an entity that has changed its
8 organizational status on several occasions to the advantage of its shareholders. Initially,
9 the Company represented that it was originally formed as an S corporation. Upon
10 questioning by RUCO, the Company admitted its mistake and testified that it was originally
11 formed as a C corporation in 1972. Transcript at 388. In 1973, the Company elected to
12 change to an S corporation. Id. In 1979, after a change in ownership, the Company
13 converted back to a C corporation. Id. at 389. In 1986, perhaps because of changes in the
14 federal tax code, the Company changed back to an S corporation which it has been ever
15 since. Id.

16 **b. Commission's long standing policy has not motivated Pima to**
17 **reorganize as a C corporation in the last 26 years.**

18 The Company's own history demonstrates that the Commission's policy on taxes had
19 nothing to do with the Company's many elections. The Company has remained a
20 Subchapter S corporation since 1986 despite the fact that it was precluded from recovering
21 shareholder personal taxes in rates. Why has the Company not changed its organizational
22 status from an S corporation since 1986 given the Commission's current policy? The
23 answer is simple - Pima benefits from S corporation. There is an old adage – "actions speak
24 louder than words". The Company's actions and those of other pass-through regulated

1 entities in this state show that the Commission's current policy does not impede investment
2 in Arizona.

3 **2. There is no evidence that utilities will reorganize as C corporations**
4 **unless S corporations and LLCs can impute recovery of**
5 **shareholder personal tax liability into rates.**

6 During the hearing, Chairman Pierce and the Company's witness, Marc Spitzer
7 discussed the notion that non-recovery of taxes penalizes S corporations and is "pushing
8 folks" into C corporation status. Transcript at 260 – 265.

9 Pima contends that if utility customers do not cover the personal tax liability of S
10 corporation shareholders, then the shareholders may elect to reorganize as a C corporation.
11 The maximum corporate income tax rate is higher than the maximum individual income tax
12 rate. A C corporation is subject to corporate income tax. Corporate income tax is an
13 identified expense of the utility and is recoverable in rates. And since the maximum
14 corporate income tax rate is higher than the individual income tax rate, the ratepayers, Pima
15 argues, would pay even higher rates if the rates included recovery for corporate income
16 taxes rather than the personal income taxes. The argument is that the additional \$235,132
17 (water) and \$255,017 (wastewater) Pima is asking for in rates to cover the personal tax
18 liability of Pima's shareholders actually saves the customers money because it stops Pima
19 from reorganizing as a C corporation. RUCO rejects this argument.

20 **a. Commission need not change its policy to attract investors.**

21 On the FERC level, Mr. Spitzer noted that the gas pipelines were desperately needed
22 throughout the country, and the investment community had made it clear that they did not
23 want to invest in the C corporations - they wanted to invest in the pass-through corporations.
24

1 Id. at 262. FERC's intent was to encourage investment in desperately needed gas pipelines.

2 Id.

3 Here, there is a completely different set of circumstances. First, the Company is built
4 out so infrastructure investment is not a concern. Second, with FERC the question centered
5 on desperately needed gas pipelines. Here, the concern is water, not gas pipelines, and
6 there is no air of desperation. Finally, there is no evidence that the Commission's current
7 policy has pushed investors to C corporations. In fact, according to Mr. Spitzer, the
8 evidence would indicate otherwise. Mr. Spitzer testified that most new entities are formed as
9 pass-through LLCs. At the time Mr. Spitzer was an Arizona Commissioner, he testified that
10 the ratio was approximately 100 to 1 and has probably gotten larger. Tr. at 186. When
11 asked if he was aware of any entities organized as a C corporation because of the
12 Commission's policy he testified that he was not aware of any. Tr. at 186-187.

13 Mr. Spitzer's testimony is consistent with Staff's witness, Mr. Carlson who also
14 testified that he had no knowledge of utilities converting to C corporations because of the
15 Commission's long standing policy and could not even recall a single entity organized as an
16 S corporation that converted to a C corporation. Tr. at 308. There is no evidence in the
17 record to support the contention that the Commission's policy is "pushing" companies to
18 organize as C corporations in Arizona.

19 **3. Increasing rates to cover shareholders' personal income tax**
20 **liability may result in an unjust enrichment to shareholders if**
21 **no taxes are actually owed.**

22 Since shareholders may offset tax liability for income earned from Pima with
23 losses from other S corporations or other investments as well as other deductions,
24 credits and exemptions, it is quite possible that monies collected for the shareholders'

1 tax liability exceed the amount of tax actually owed. When this happens, this is
2 essentially free money for the shareholders paid by the ratepayers who receive no
3 benefit from these payments.

4 Pima dismisses the important fact that the shareholder can avoid paying taxes
5 by claiming losses from other investments. For example, a shareholder of a profitable
6 S corporation utility who also realized losses from ownership of a real estate
7 development business can apply those losses to offset earnings derived from the
8 utility. Additionally, a shareholder can apply numerous exemptions, deductions and
9 tax credits that are available to the individual taxpayer but not to a corporation.
10 Examples include exemptions for minor children, deductions for health savings
11 accounts, moving expenses, student loan interest, child tax credit, dependent care tax
12 credit, residential energy credits, and retirement savings credit.

13 Pima argues that it does not matter if the tax rate set in rates does not exactly
14 match the taxes actually paid by the shareholder. After all, argues the Company, most
15 times the amount collected to pay the corporate income tax liability of a utility
16 organized as a C corporation does not match the amount of taxes actually paid by the
17 utility.

18 RUCO disagrees with this logic. There is a big difference between the
19 possibility of excess funds collected to pay corporate income taxes and to pay
20 personal income taxes. Even if a C corporation utility paid less in taxes than what was
21 recovered in rates, those excess funds stay with the utility. Those funds are available
22 for use for utility purposes. And in a test year, that revenue collected that exceeded
23 the tax bill is calculated into the utility's test year operating income and will offset a rate
24

1 increase. With the S corporation, the monies that the customers would pay for income
2 tax would go straight into the shareholders' pockets, and any difference is not retained
3 by the Company for the benefit of the utility and ultimately the ratepayer.¹⁴

4
5 **C. ALLOWING A SUBCHAPTER S CORPORATION TO RECOVER INCOME**
6 **TAX FROM RATEPAYERS WOULD VIOLATE THE COMMISSION'S**
7 **CONSTITUTIONAL OBLIGATION TO PRESCRIBE JUST AND**
8 **REASONABLE RATES.**

9
10 **1. The Company's proposal violates Arizona's Constitution because**
11 **the Company does not pay income tax and, therefore, income tax**
12 **is not part of the Company's operating costs.**

13 The Arizona Corporation Commission is established by Article 15, Section 1 of the
14 Arizona Constitution. The Commission's authority is derived from Article 15, Section 3, which
15 provides, in relevant part, that the Commission "shall have full power to, and shall, prescribe
16 just and reasonable classifications to be used and just and reasonable rates and charges to
17 be made and collected, by public service corporations within the State for service rendered
18 therein." Ariz. Const. Art. 15, § 3.

19 Although the Commission's authority to prescribe rates is plenary, Tucson Elec.
20 Power v. ACC, 132 Ariz. 240, 242, the Commission's rate-making authority is not unlimited
21 and is subject to the "just and reasonable" clauses of Article 15, Section 3 of the Arizona
22 Constitution. The Constitution obligates the Commission to consider and protect the
23 ratepayers' interests when determining "just and reasonable rates".

24 The Commission was created by the states Founding Fathers to shield the
ratepayers against overreaching by public service corporations. Deborah Scott Engleby,

¹⁴ RUCO recognizes that shareholders may elect not to take the full distribution of income earned by the Company, but is still liable for the taxes on the full amount. However, this decision of the amount of the

1 "The Corporation Commission: Preserving its Independence", (20 Ariz. St. L.J. 241, 242
2 (1988)) At the time of Arizona's Constitutional Convention, there was such a feeling of
3 mistrust of government, including future legislatures, that the delegates, in order to
4 guarantee "the people security against the dominance of corporate and corrupt control of
5 public affairs..." safeguarded against any legislative encroachment by giving the Legislature
6 authority to enlarge the Commission's powers, but no authority to diminish them. Id. at 244.
7 The result was a public service commission with more power than any other state at the
8 time. State v. Tucson Gas, 15 Ariz. 294, 300, 138 P. 781, 783 (1914).

9 The Arizona courts have long since recognized the Commission's constitutional
10 obligation to protect the financial interest of the consumer. See for example Southern Pac.
11 Co. v. Arizona Corp. Comm'n, 98 Ariz. 339, 342, 404 P.2d 692, 694 (1965), and also Cogent
12 Public Service v. Ariz. Corp. Comm'n, 142 Ariz. 52, 56, 699 P.2d 698, 02 (App. 1984) ("It
13 has long been the policy of our courts to recognize that the setting of utility rates must take
14 into account the interests of utility customers as well as utility shareholders."). The Arizona
15 Supreme Court has even said that the people of Arizona created the Commission primarily
16 for the interests of the consumer.

17 "All persons agree that the capital invested in public service should receive
18 reasonable remuneration, and that the services rendered should be efficient
19 and practicable and to all patrons upon equal terms and conditions. With a
20 full knowledge that these things had not been accomplished under the laws
21 heretofore existing in this and other jurisdictions, the people in their
22 fundamental law created the Corporation Commission, and clothed it with full
23 power to investigate, hear, and determine disputes and controversies
24 between public utility companies and the general public. This was done
primarily for the interest of the consumer." (Tucson Gas, supra at 307-308,
138 P. 781-786)

24 distribution is made solely by the shareholders in the full discretion.

1 Clearly and without question the Commission was given unique and extensive powers
2 primarily to protect the consumers' financial interests.

3 In order to prescribe rates that are just and reasonable and protect the consumer's
4 financial interests, Arizona's Supreme Court has held that when setting rates for public
5 utilities, the Commission should focus on the principle that "total revenue, including income
6 from rates and charges, should be sufficient to meet a utility's operating costs and to give the
7 utility and its stockholders a reasonable rate of return on the utility's investment." Simms v.
8 Round Valley Light & Power Co., 80 Ariz. 145, 153, 294 P.2d. 378, 383 (1956), Scates v.
9 Arizona Corp. Comm'n, 118 Ariz. 531, 533-34, 578 P.2d 612, 614-15 (App.1978). Arizona's
10 Courts have made it clear that a predicate for determining just and reasonable rates is the
11 Company's operating costs. The amount of revenue awarded should be sufficient to meet
12 the utility's operating costs. Id.

13 The Company's proposal violates Arizona's Constitution because the Company does
14 not pay income tax, and therefore income tax is not part of the Company's operating costs.
15 Setting rates based on an operating expense that does not exist will not result in just and
16 reasonable rates and is therefore unconstitutional.

17 Since the Company does not pay income tax, there are several reasons why the
18 Company's proposal does not protect, but actually hurts, the ratepayers' financial interests.
19 First, If the Company is allowed to recover from ratepayers the phantom income tax, not only
20 would the Company avoid paying corporate income tax, the Company's shareholder's would
21 essentially not have to pay personal income tax on the income revenues received from their
22 investment in the utility. By no means could this type of ratemaking be considered balancing
23
24

1 the interests of both the ratepayer and the shareholder – it only considers the shareholder's
2 interest. The rates that would result from such ratemaking could not be just or reasonable.

3 **2. Since shareholders may have different individual tax rates and**
4 **different offsets, any rate the Commission sets would be arbitrary.**

5 There is no manner in which a system could be developed that would guarantee that
6 ratepayers would pay the appropriate amount of income tax. In other words, the amount of
7 tax recovered would be arbitrary and therefore, not just and reasonable. Staff's witness,
8 Darron Carlson points out that the calculation of corporate income tax and personal income
9 tax are completely different. Tr. at 307. Taxable income for a C corporation for example is
10 based on the net income from the business. Id. Taxable income for the individual is based
11 on the transfer of income in any number of ways including salaries, interest, dividends,
12 supplemental income, etc. Id. The individual income tax rate will be the same for all of
13 those income sources with no preferential tax treatment for any source in particular. Id. at
14 307-308. There is no fair way to reconcile the shareholder's personal income tax with a
15 corporate income tax rate that will guarantee that ratepayers will pay an appropriate and fair
16 amount of income tax. As Mr. Carlson notes, about the best we can do is "damage" the
17 ratepayer as little as possible¹⁵. Id. at 326 – 327.

18 The Commission is obligated to set rates that are just and reasonable. The
19 Commission must base those rates on the Company's operating costs. The Commission
20

21 ¹⁵ Mr. Carlson testified that even on the FERC level the FERC drove down to the taxpayer level and determined
22 the weighted cost. Id. at 326. On the taxpayer level, the Commission would require the shareholder's personal
23 tax return. Id. The logistics of obtaining those returns, assuming the shareholders would voluntarily produce
24 them, would be nothing short of a nightmare and truly burdensome on an already overburdened Commission
Staff.

1 cannot legally base rates on operating costs that do not exist. The Company's proposal
2 violates Arizona's law.

3 **RELIEF REQUESTED:** The Commission should adopt RUCO's recommendation to
4 reject the Company's proposal to recover \$235,132 in income tax expense for Pima's Water
5 Division, and \$255,017 in income tax expense for the Company's Wastewater Division. The
6 Commission should also adopt RUCO's adjustments which remove Company-proposed
7 adjusted test year income tax expense levels for both the Water Division and the
8 Wastewater Division.

9 10 **II. OTHER OPERATING EXPENSE ISSUES**

11 **A. DEPRECIATION EXPENSE – WATER DIVISION**

12 RUCO made a minor adjustment of \$550 which centers around the appropriate plant
13 classifications for plant that was originally recorded as expenses. Transcript at 142. RUCO
14 recorded the plant based on information in responses to the Company's data requests. Id.
15 at 143.

16 **RELIEF REQUESTED:** The Commission should adopt RUCO's \$550 adjustment,
17 which is included in RUCO's depreciation expense adjustment of \$1,939, and approve
18 RUCO's recommended level of depreciation expense of \$688,936.

19 20 **B. SALARY AND WAGE EXPENSE WATER AND WASTEWATER 21 DIVISION**

22 At issue is the salary of the Company's Chairman of the Board of Directors, Mr.
23 Robson. Originally, the Company requested \$90,294 for Mr. Robson in salary for each
24

1 Division. Transcript at 144. RUCO believed, and still believes, that \$90,294 per Division is
2 excessive given the reported 56.68 hours that Mr. Robson reportedly worked. R-3 at 21. R-
3 2. The Company has since declared that the 56.68 hours it reported for Mr. Robson on its
4 Schedules of Salaries for the Water and Wastewater Divisions was a mistake because, in
5 fact, Mr. Robson does not maintain a time sheet. Transcript at 56.

6 The Company has also reduced its request for Mr. Robson's salary to \$40,198 per
7 Division. The reduction in salary request is the Company's attempt to compromise. A-10 at
8 11. The Company came up with this amount based on the salary level approved in the last
9 rate case and escalated it for inflation. Id. RUCO appreciates the Company's attempt to
10 compromise, but does not believe the Company's logic is persuasive.

11 The Company bears the burden of proof to present evidence of its prudently incurred
12 expenses. To meet this burden, it presented documentation to support the pay for its
13 employees. Now, it claims the Commission should continue to rely on this documentation
14 for all employees except one, Mr. Robson.

15 RUCO questions the "mistake" and hence the salary request for Mr. Robson. The
16 hours reported on the schedules is an oddly precise number and had to be based on
17 something. When asked, the Company's witness, Mr. Soriano testified that "... the error
18 came from somebody trying to be helpful in calculating out what the effects of one number
19 divided by another number would have been..." Transcript at 57. The Company's "mistake"
20 calls into question the reliability of the hours of all of its employees on its salary schedule.
21 Given that Mr. Robson is the principal in numerous corporations and does not keep
22 timecards there is no verifiable way to ascertain the number of hours Mr. Robson committed
23 to Pima.

1 This concern is further exacerbated by the fact that Mr. Robson is a principal in
2 several other smaller utilities and he allocates his time among all of the utilities including
3 Pima. Transcript at 67. Mr. Robson's allocates his time on a company-by-company basis
4 subject to the approval of each company's Board of Directors. Id. Yet, he takes no salary
5 from the other utilities. Tr. at 67-68, 84) The fact that Mr. Robson allocates his time among
6 many utilities raises the concern that Pima's ratepayers will be subsidizing Mr. Robson's
7 time devoted to his other businesses. The initial large salary request, the reporting mistake,
8 and the lack of any time keeping or verifiable means to support the Mr. Robson's current
9 salary request are all persuasive reasons to reject the Company's request.

10 RUCO is recommending a salary of \$7,085 per Division. RUCO's recommendation is
11 based on the number of hours reported multiplied by \$125 per hour. The hourly rate of \$125
12 is based on a comparable CEO of a Class A Water Company within the local area (Arizona
13 Water Company in 2008). R-4 at 18, Transcript at 145. RUCO's recommendation is fair
14 under the facts of this case and should be adopted.

15 **RELIEF REQUESTED:** The Commission should adopt RUCO's recommended salary
16 of \$7,085 per Division for Mr. Robson per Division.

1 **C. RATE CASE EXPENSE**

2 There are two issues in dispute, the amount of rate case expense and the method of
3 recovery. RUCO is recommending \$150,000 in rate case expense per Division and that it be
4 normalized over four years. R-6 at 9. The Company proposes \$200,000 per Division in rate
5 case expense and that it is recovered via a surcharge over five years rather than in base
6 rates. Id. at 8.

7 **1. Amount of Rate Case Expense**

8 With regard to the amount of rate case expense, RUCO believes that \$200,000 is
9 excessive. RUCO's recommendation of \$150,000 is based on an in depth analysis of rate
10 case expense awarded in other water utility cases. In American Water Company's ("AWC")
11 Northern and Eastern Groups¹⁶, which were comprised of five and eight individual water
12 systems respectively, the Commission approved a total of \$250,000 in rate case expense for
13 each Group, or \$50,000 more than Pima's requested level of expense in this proceeding. R-
14 5 at 23. The Commission later authorized \$250,000 in rate case expense for a case
15 involving AWC's Western Group¹⁷ which was comprised of five separate water systems. Id.
16 In the most recent rate cases for AWC's Western and Eastern Groups, AWC requested total
17 rate case expense of \$626,156¹⁸ and \$476,874 respectively. While these requested
18 amounts are \$226,156 and \$76,874 higher than the \$400,000 that Pima is seeking for both
19 its Water and Wastewater Systems, it has to be remembered that AWC is a statewide Class
20 A utility and its filings consisted of multiple water systems where this case only involved two
21 operating divisions. Id.

22 _____
23 ¹⁶ Decision No. Decision No. 64282, dated December 28, 2001 and Decision No. 66849, dated March 19,
2005

24 ¹⁷ Decision No. 68302, dated November 14, 2005

1 In the recent UNS Gas rate case ("UNSG"), UNSG requested a total rate case
2 expense of \$700,000. UNSG is a Class A public service corporation that serves far more
3 customers over a much larger service territory than Pima. UNSG's rate case is much bigger,
4 involved more parties and also deals with more complex ratemaking issues such as
5 decoupling. Both ACC Staff and RUCO are recommending that UNSG's requested level of
6 expense be reduced to \$400,000, which is the same amount that Pima is requesting for the
7 Company's Water and Wastewater Divisions combined. Id. at 24.

8 Based on the comparisons provided above RUCO believes that its \$300,000
9 recommended level of rate case expense is reasonable and should be adopted by the
10 Commission.

11 **2. Method of Recovery**

12 On the issue of the method of recovery, RUCO recommends that the rate case
13 expense be normalized over four years. Normally, rate case expense is amortized /
14 normalized over a short period of years that is reflective of the typical amount of time a utility
15 stays out between rate cases. Id. at 25. However, Pima has not come in for rate cases very
16 often. The water division filed its last rate case with a Test Year ending December 31, 1992
17 while the wastewater division's last rate case was filed with a Test Year ending December
18 31, 1997. Id. The Company has reached build out and RUCO has no reason to believe that
19 this Company will come in for another rate case in the near future. Id.

20 If history repeats itself, and it normally does, this long stay out would result in a
21 windfall to the Company under the traditional normalization scenario since rate case
22 expense is a non-recurring expense that will be collected through rates until the Company's
23

24 ¹⁸ AWC eventually agreed to RUCO's total rate case expense figure of \$304,975

1 next rate case. For example, this scenario is based on the Company's original Wastewater
2 Division's requested amount of annual rate case expense of \$50,000 (\$200,000 of total rate
3 case expense / amortized over 4 years = \$50,000 of annual rate case expense). Id. at 25. If
4 the Company does not file another rate case for another 20 years, the Company would
5 collect \$1,000,000 (\$50,000 of annual rate case expense x 20 years = \$1,000,000) in rate
6 case expense through its base rates from Pima's ratepayers. Id. at 26. If the Company does
7 not file another rate case for 15 years, Pima would collect \$750,000 in rate case expense
8 through its base rates. This amounts to an over-collection of rate case expense of five-fold
9 in the 20 year scenario and 3.75 times in the 15 year scenario. Id. Had the Commission
10 authorized a \$50,000 annual rate case expense in Decision Nos. 58743 and 62184 dated
11 August 11, 1994, and January 5, 2000 respectively, the scenario described above would
12 have actually happened. Id.

13 RUCO is concerned that the Company may stay out for a long period because Pima
14 Utility Company's service area is built out and there are limited reasons in the foreseeable
15 future for the Company to file another rate case anytime soon. Id. To address this concern,
16 RUCO offered three different options that would prevent the above scenario from happening.
17 Id. First, a surcharge for rate case expense could be applied as a separate line item on the
18 customers' bill. When the rate case expense authorized in this proceeding has been fully
19 collected through the surcharge, the surcharge would be eliminated and nothing but base
20 rates would apply going forward. Id. at 26-27. The second option is to extend the
21 normalization period to ten years. This option would lower rates. If the Company were to file
22 a rate case prior to fully collecting the authorized rate case expense, RUCO recommends
23 that the Company be granted a deferred accounting order, which would allow Pima to
24

1 amortize the remaining unrecovered expense over some period of time. This option
2 completely eliminates the possibility of under-collecting the authorized level of rate case
3 expense. The third option simply reduces the Company's level of authorized rate case with
4 no deferred accounting order. Id.

5 Of the three options, RUCO recommends the second option. Increasing the
6 normalization will ameliorate the rate impact on ratepayers. It will further avoid the often
7 unfavorable response of the public to a surcharge. And the deferral order ensures full
8 recovery of rate case expense for Pima. However, RUCO would not oppose the other two
9 options, including the surcharge option in view of the facts in this case.

10 **RELIEF REQUESTED:** The Commission should adopt RUCO's adjustment of
11 \$50,000 per Division for rate case expense and approve RUCO's recommended rate case
12 expense of \$150,000 per Division amortized over four years.

14 **III. CONTESTED RATE BASE ADJUSTMENTS**

15 **A. CONVERSION OF ADVANCES IN AID OF CONSTRUCTION ("AIAC") TO** 16 **CONTRIBUTIONS IN AID OF CONSTRUCTION ("CIAC")**

17 **WATER DIVISION**

18 During the discovery phase, the Company determined that it had a single line
19 extension contract recorded as AIAC in the Wastewater Division. R-5 at 11. The Company
20 stated the following:

21 Due to the bankruptcy of the developer, Pima has been unable to
22 pay the refunds due to the developer and is unaware of a
23 successor entity to which payments can be made. Since it is
24 unlikely that Pima will ever be able to actually pay the amounts
due, Pima believes it may be more appropriate to eliminate the

1 account payable to the developer and reclassify the full amount of
2 the original advance to Contributions in Aid of Construction.

3 Id. at 11- 12. RUCO agreed with the Company's suggestion to reclassify the AIAC balance
4 as CIAC for both the Water and Wastewater Divisions since the refunds were not paid to the
5 developer nor did it appear that there was an obligation at that point in time. Id. at 12. In its
6 direct case, RUCO reversed the Company's net AIAC balance of \$285,313 to zero and
7 added the gross AIAC balance of \$343,412 to CIAC. Id. RUCO's position did not change in
8 its Surrebuttal case. R-6 at 2.

9 The Company, in its Notice of Late Filed Exhibits explained the events that transpired
10 on this issue during the hearing of this matter:

11 By way of explanation, during the trial Staff introduced Hearing
12 Exhibit S-3¹⁹. This SEC filing suggested that Meritage might have
13 succeeded Hancock-MTH before the Hancock bankruptcy²⁰. In an
14 effort to eliminate an issue in dispute, the Company agreed to and
15 did contact Meritage to determine for certain that they were the
16 successor entity²¹. Meritage confirmed that it is the successor as the
17 letter dated June 18, 2012 from Meritage filed herewith reflects. (See
18 Exhibit 1.)

19 Having found the developer under the LXAs, Pima further
20 represented that it would pay the refunds due under the LXAs and
21 propose pro forma adjustments in its final schedules²². Staff's
22 witness agreed that payment of the refund would constitute a known
23 and measurable change to the test year and agreed to make the
24 appropriate adjustments in its final schedules²³. Those refunds have
now been paid as reflected in the copies of the two checks and the
letter dated June 19, 2012 acknowledging receipt filed herewith. (see
Exhibits 2 and 3.)

Pima's Notice of Filing Late Filed Exhibits at 2-3.

22 ¹⁹ Staff counsel did provide a copy of this document to undersigned counsel just prior to trial.

23 ²⁰ Tr. at 109:13 - 110:13

24 ²¹ Id. at 110:19 - 111:6.

²² Id. at 461:17 - 462:6.

²³ Id-; see also id. at 462:7-20,

1 RUCO's original recommendation to reclassify the AIAC balance as CIAC for both the
2 Water and the Wastewater Division was based on the assumption that the refunds were not
3 paid to the developer and that there was no obligation to make the refunds. The new
4 evidence, which no party disputes, clearly establishes a current obligation which the
5 Company has satisfied. Since the Company has made the refunds, RUCO believes its
6 original treatment of converting the AIAC to CIAC for the Water and Wastewater Divisions is
7 no longer appropriate. For the Water Division, because the line extension Agreement does
8 not expire until June, 2014, RUCO recommends that the AIAC remain AIAC and not be
9 converted to CIAC which is the standard ratemaking treatment for payment of refunds of this
10 nature²⁴. This accounting treatment is reflected in RUCO's revised final schedules for
11 Pima's Water Division.

13 **WASTEWATER DIVISION**

14 On the wastewater side RUCO is not reversing its adjustment. The AIAC associated
15 with the main extension agreement for the Wastewater Division expired in June, 2009. This
16 is when the unpaid obligation should have been converted to CIAC. Transcript at 341-342,
17 S-1. Accordingly, RUCO believes that the proper ratemaking treatment is to make an
18 adjustment to the amortization of the CIAC for \$22,995. RUCO's adjustment will have the
19 effect of increasing revenue by approximately \$6,569.

20 **RELIEF REQUESTED:** The Commission should adopt RUCO's recommended AIAC
21 levels of \$374,236 for Pima's Water Division and \$0 for the Company's Wastewater Division.
22

23
24 ²⁴ This change in recommendation should come as no surprise as RUCO's witness, Tim Coley, testified
on the stand that the new evidence could and would likely effect RUCO's recommendation.

1 The Commission should also adopt RUCO's recommended CIAC levels of \$632,417 for
2 Pima's Water Division and \$1,242,739 for the wastewater division. The Commission should
3 further adopt RUCO's recommended level of \$601,087 for the Wastewater Division's
4 accumulated amortization of CIAC.

6 **IV. COST OF CAPITAL**

7 RUCO and the Company are in agreement on the 4.25 percent Company proposed
8 long term debt and the Company's end of test year capital structure of 35.36 percent long-
9 term debt and 64.64 percent common equity. R-10 at 12. The Company's proposed 10.50
10 percent cost of equity remains in dispute. Id. Both RUCO and Staff are recommending a
11 9.40 percent cost of common equity. For the following reasons, RUCO recommends the
12 Commission adopt a 9.4 percent cost of equity.

13 The Company's cost of equity recommendation is too high given the current
14 environment of low inflation and low interest rates in which the Company is operating.
15 Moreover, RUCO witness, Mr. William Rigsby's testified that RUCO's recommendation is
16 further supported by the Federal Reserve's current policy to keep interest rates low for an
17 extended period of time and Value Line analyst's projection of interest rate costs. R-10 at
18 14.

19 The Company claims that it faces business risk because of its small size compared
20 to sample companies and the regulatory environment the Company faces in Arizona. A-7
21 at 23. Even if there is a basis for the Company's argument, it does not justify a cost of
22 equity recommendation of 10.5 percent. Nor is the Company's suggestion that it faces
23
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1 higher risk due to Arizona's regulatory environment persuasive. The Company's cost of
2 capital recommendation should be rejected.

3 In terms of risk, RUCO's recommended 9.40 percent cost of equity, if anything, is
4 fair and reasonable. RUCO could have easily recommended a lower cost of equity based
5 on the average of its DCF and CAPM results. Instead, RUCO is recommending a cost of
6 common equity that is close to the higher result obtained from Mr. Rigsby's natural gas
7 sample which is close to Value Line's long-term 9.50 projection for the water utility industry
8 as a whole. R-10 at 15. In short, RUCO's cost of capital recommendation is well
9 reasoned, reasonable, fair, and should be adopted by the Commission.

10 **RELIEF REQUESTED:** The Commission should adopt RUCO's 9.40 percent cost
11 of equity recommendation.

12 **V. RATE DESIGN**

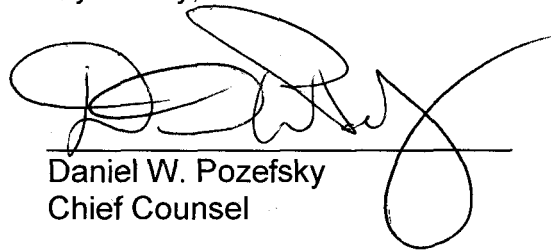
13 RUCO and the Company have proposed similar rate designs with one exception. R-6
14 at 16. That exception is the difference between PIMA and RUCO's overall gross revenue
15 increase. Id.

17 **VI. CONCLUSION**

18 For the reasons discussed above, RUCO recommends the Commission adopt its
19 position in this case, and reject the positions of Staff and the Company, to the extent they
20 conflict.

1 RESPECTFULLY SUBMITTED this 3rd day of July, 2012.

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Daniel W. Pozefsky
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